

Central Intelligence Agency



Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

6 April 1983

Hong Kong: The Coming Year

Summary

We expect little progress this year in the Sino-British talks on Hong Kong, which are deadlocked over the sovereignty question. London is withholding recognition of Chinese sovereignty over the colony in an effort to obtain satisfactory terms for the transfer of authority. The Thatcher government clearly hopes to persuade Beijing to let Britain continue to play a role - at least in running the economy - after 1997 to bolster its domestic political position and to help calm local concerns. [redacted] 25X1

Chinese leaders, however, have not yet decided on a plan for administering Hong Kong. To keep their options open and maintain pressure on the British, they are insisting that Britain cede sovereignty before substantive negotiations begin. Meanwhile, Beijing is trying--without much success--to reassure the colony's residents by floating an autonomy plan that would allow Hong Kong to retain its present social and economic system. We believe the Chinese offer also is intended to encourage Taiwan to consider negotiating similar arrangements. [redacted] 25X1

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This memorandum was prepared by [redacted] the Office of East Asian Analysis, China, Foreign Affairs Branch and [redacted] the Office of East Asian Analysis, China, Development Issues Branch. Questions and comments are welcome and may be directed to the authors [redacted] 25X1

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Despite this standoff, the colony's economy is beginning to recover from the slump that followed the Thatcher visit. Prospects this year for Hong Kong's export driven economy are good, although the recovery probably would be stronger if the political situation were more predictable. Ironically, Beijing may misinterpret this recovery as a sign that the colony's investors accept their autonomy proposal, and thus may become even less willing to consider a compromise. [] 25X1

Neither Beijing nor London now appears ready to adopt a more flexible negotiating stance, although British leaders may feel freer to compromise on the sovereignty question after Britain's next general elections. Should Britain unexpectedly cave in, existing US agreements with the colony could become invalid. []

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The Thatcher Visit

Prime Minister Thatcher's discussions with Chinese leaders last September over Hong Kong were contentious. Deng Xiaoping told Thatcher that China would recover its sovereignty in 1997 and declared the issue non-negotiable. []

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The Chinese infuriated the British by adding a line to the joint statement reiterating their position on the sovereignty issue. After Thatcher subsequently told a press conference in Hong Kong that the three treaties establishing the colony were still valid, Beijing lashed out in a strongly-worded Xinhua commentary, restating China's position that Hong Kong is Chinese territory. [] 25X1

The unsuccessful talks prompted a sharp downturn in the mercurial Hong Kong stock market. The Hang Seng index, already slipping as a result of worldwide recession, dropped more than 300 points between 1 September and 31 October. More importantly, Hong Kong's international financial market--third largest in the world and a major source of capital--reacted negatively. Singapore, Thailand and the United States reportedly all received major injections of Hong Kong capital in late 1982. The Hong Kong dollar also depreciated 12 percent in September and October alone. Visa applications and inquiries also rose sharply as Hong

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Kong residents sought to insure themselves against the uncertainties associated with a Chinese takeover. [REDACTED]

This near-panic, coming at a time when the domestic economy was already reeling from the effects of the worldwide economic recession, hit several deposit-taking companies and major land companies hard, forcing them to default on loans totalling over \$1 billion. Without the determined efforts of several of Hong Kong's leading financial institutions, most experts believe that other large industrial and financial institutions would have followed suit. Even so, bankruptcies reached a 20-year peak in 1982 and were up more than 50 percent from the 1981 level. [REDACTED]

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The Current Hiatus

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Neither side seems disturbed by the lack of progress. The British are using the interlude to educate the Chinese on the complexities of administering Hong Kong, hoping to convince China to allow London to continue to play a management role after 1997. The British have used Hong Kong businessmen travelling to Beijing to get across their message. The Chinese seem content to stand pat and are trying to gain public support in the colony to put pressure on the British. As part of this effort, China initiated a propaganda offensive in Hong Kong last fall designed to calm local jitters and to float various proposals for the colony's future. [REDACTED]

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Beijing is currently promoting the notion of Hong Kong becoming a special administrative zone in 1997 under Article 31 of China's recently enacted constitution. Hong Kong would basically retain its existing social and economic structure and would be locally administered. The details remain vague. At a minimum, the British governor and flag would be removed, but Beijing has indicated it would allow some British civil servants to remain to help with the transition. [REDACTED]

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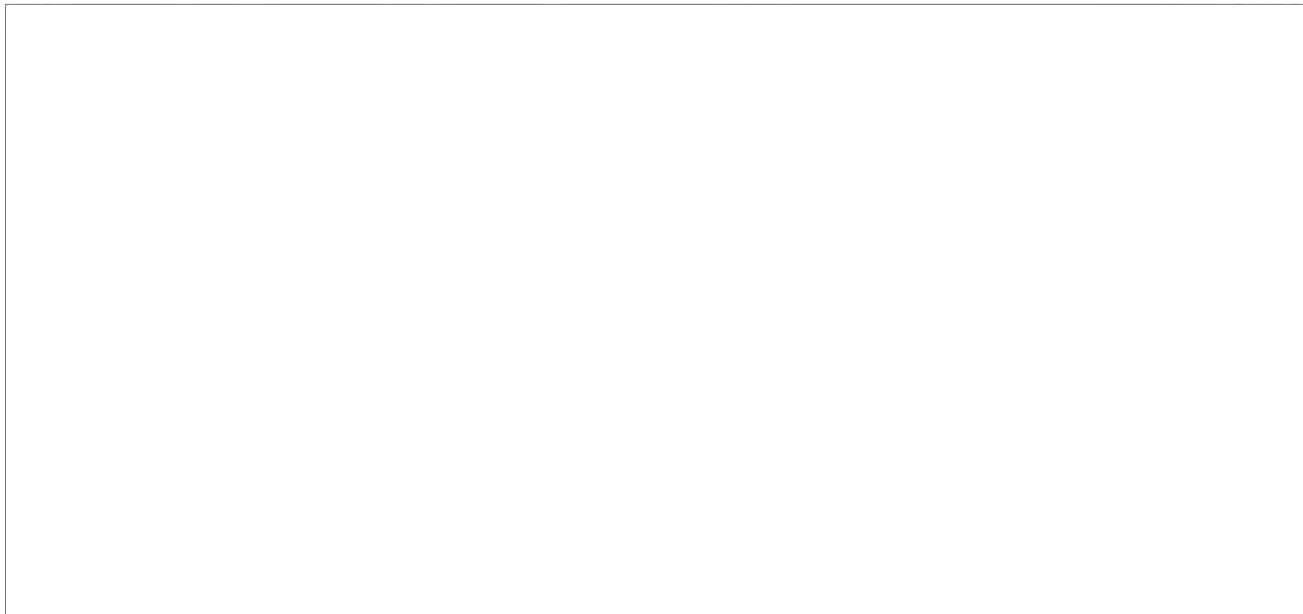
Thus far, Beijing's efforts to reassure the Hong Kong public have not gone well. In one case, Premier Zhao Ziyang had to disavow the statements of the leader of a visiting overseas Chinese delegation who reported that China might retake Hong Kong before 1997. [REDACTED]

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In the meantime, the Hong Kong economy has recovered somewhat from its November nadir as investors have come to realize that there will be no quick solution to the 1997 problem. The stock market bottomed out in November, picked up steam in December, and then jumped more than 100 points in January--back to pre-Thatcher visit levels. Overall economic growth was about 2.4 percent in 1982, good by Western standards but well below Hong Kong's 10 percent average for the past decade. [redacted]

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Economic prospects for 1983 are brighter. As the West moves out of recession Hong Kong's export-led economy is likely to turn upward. The increase should be enhanced by falling oil prices which will generate increased demand for Hong Kong consumer goods. The improvement could lead to real increases of as much as 6 percent in GDP for the year. Price pressures may also ease as signs of domestic prosperity and lower international interest rates increase the flow of foreign funds into the now undervalued Hong Kong currency. [redacted]

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Constraints on China's Hong Kong Policy

In formulating plans for the future of Hong Kong, Chinese leaders will have to reconcile several potentially conflicting interests. Foremost of these is their concern over the impact of a takeover on the colony's economic vitality. Sizeable amounts of Western equipment, technology, and managerial skills continue to be funneled through Hong Kong into China and, by its own account, fully 31 percent of China's annual foreign exchange revenues originate in the colony. In order to satisfy the colony's residents, China will have to offer credible guarantees that the colony's economic and social systems will not be dismantled. Beijing may also be concerned over the impact negotiations with the British could have on prospects for reunification talks with Taiwan. Beijing wants to demonstrate to Taipei that it is willing to let two different social and

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economic systems operate under one flag. []

Growing nationalistic feelings may circumscribe the room Deng and his supporters have to maneuver. Some Chinese probably are more concerned about obtaining a settlement that restores China's honor than they are about the colony's economy. We believe that this is a factor in China's demand that London acknowledge Chinese sovereignty over the colony. To some extent Deng could also be vulnerable to sniping by ideological conservatives concerned about the spread of "decadent" foreign influences in China as a result of the open door policy. Conservatives probably are already disturbed by suggestions in Hong Kong's leftist press that China will allow such activities as horse racing and dancing to continue once the colony reverts to Chinese control. []

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No Settlement Likely This Year

We believe China and Britain are unlikely to reach a settlement this year. The Thatcher government will be in no mood to concede on the sovereignty issue until after the next British elections, which must be held before June 1984. Nor is Britain likely to concede sovereignty until it has received at least some general assurances about arrangements for the transfer of authority. The British want to reassure the colony's residents that London intends to stand by them. Giving in too soon on the sovereignty issue could destroy business confidence in Hong Kong and possibly precipitate a panic. Even when the sovereignty stalemate is broken, we expect the negotiations over the transfer of authority to be lengthy and contentious. []

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[] British economic stakes and considerations of potential refugee problems, however, mean that the policies of these parties if they were in power probably would not be fundamentally different from those of the Conservatives. []

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If, as we expect, economic conditions in Hong Kong continue to improve, Beijing is unlikely to relax its demand that Britain acknowledge Chinese sovereignty. We believe Chinese leaders have overestimated their ability to play a larger role in Hong Kong affairs after 1997 without seriously harming the economy during the intervening years. Chinese leaders probably will interpret a sharp economic upturn in 1983 as a sign that Hong Kong investors share this belief, reinforcing Beijing's myopic perspective. []

Possible Problems

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Although we believe Hong Kong's prospects for economic and political stability in 1983 are good, miscalculation by either side could upset the relatively calm atmosphere. For example, a premature British concession on the sovereignty issue or

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alternatively a serious breakdown in discussions, if mishandled, could lead to major capital flight. Large outflows would have long-term detrimental effects on growth prospects. Even small domestic investors would probably hedge their bets ^{by} turning to ventures elsewhere. [] 25X1

The Hong Kong government probably would intervene in the economy if major capital outflows threatened the system. Beijing's Hong Kong branch of the Bank of China also would step in to stabilize the economy. The Bank has already been involved in several major land deals--including a \$200 million 75-year renewable lease on land for a new office building--as part of its effort to assuage investors fears about the colony's future. In late 1982 the Bank of China also actively defended the Hong Kong dollar against downward speculative pressures. In its most recent gesture, the bank last month began offering Hong Kong's small manufacturers unsecured cut-rate loans. [] 25X1

The development of local interest groups in Hong Kong favoring a particular solution could complicate the quest for a solution. One such group, called Meeting Point, was recently formed. Composed mainly of academics, journalists, social workers, lawyers, and businessmen, this relatively small group has come out in support of Beijing's basic plan. Its members, however, also favor greater democracy for the colony. The activities of Meeting Point could eventually encourage other groups less well disposed toward China to demand a voice both in running Hong Kong and in the talks over its future--a development Beijing would not welcome. [] 25X1

Thus far, Taiwan has not used its influence in Hong Kong to impede negotiations; Taipei has simply said it will not recognize any transfer of sovereignty to Beijing. Taiwan businessmen, who have a large economic stake in the colony, might line up quietly with local interests to try to obstruct the talks with the aim of extracting maximum Chinese concessions. Although Taipei might favor such footdragging to delay an agreement, the government would be loathe to become enmeshed in the negotiations. []

US Interests

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We believe US interests in Hong Kong will remain largely unaffected over the short run, unless the British unexpectedly concede sovereignty over Hong Kong. Existing US agreements with Hong Kong could then become invalid. For example, quotas for US textile imports from Hong Kong, which exceed those from China, might have to be renegotiated. US-British agreements for naval port calls and the use of Kai Tak airport might also become invalid. Many of the approximately 150,000 residents of Hong Kong who currently hold valid US visas could decide to flee to the United States. Some of Hong Kong's other 5 million residents would almost certainly seek to come to the United States. []

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Further Down the Road

In the absence of fundamental changes in the policy stance of London and Beijing, we expect Hong Kong gradually will lose its economic vitality. With the 1997 deadline still 14 years away, investors probably continue to see sizeable short term opportunities in the Hong Kong market. But as a Chinese takeover looms larger, we expect Hong Kong businessmen to begin placing their funds increasingly in more secure markets such as Singapore, Japan, and the United States.

A gradual economic downturn--especially one that occurs at a time when China's traditional trade competitors are making continuous gains--will probably encourage Beijing to seek greater British cooperation. However, the extent to which Britain will play a role in the post-1997 government, and the firmness of Chinese guarantees against intervention in Hong Kong business affairs, probably will depend on how much Beijing believes it has to pay to maintain Hong Kong's economic viability.

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- 1 - John E. Ray, Assistant U.S. Trade Representative

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- 1 - Dr. Raymond Albright

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- 1 - Chief, Asian Section, DIA

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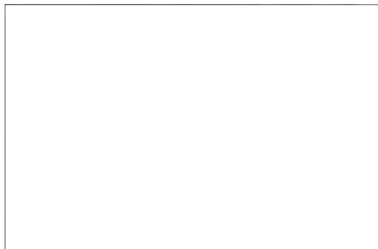
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